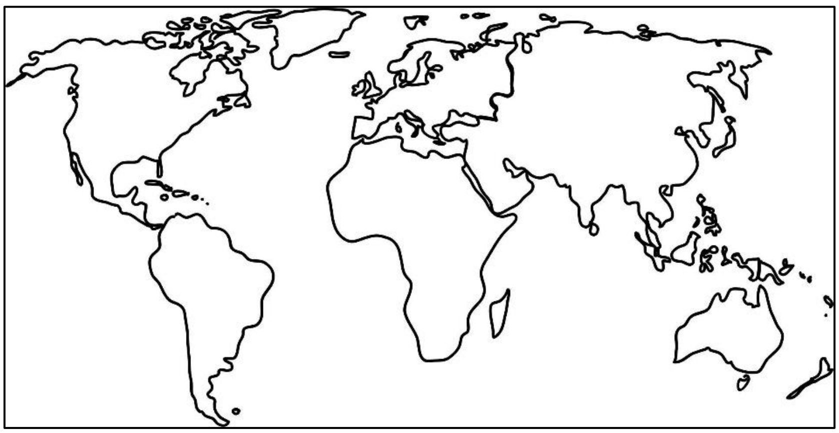
Topic 7 – International Trade



I can understand how Economics can help me reflect on issues of trade between countries and to understand the impact of countries having different currencies and that of countries using a common currency.

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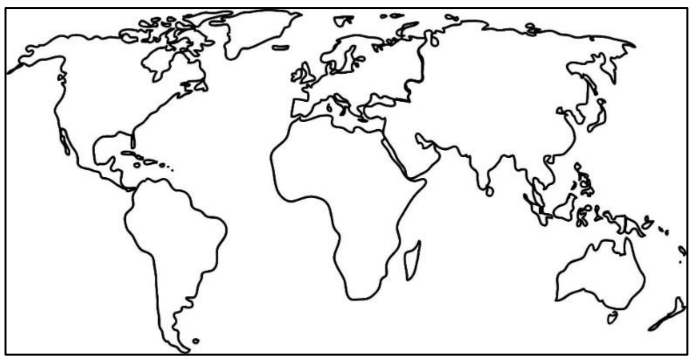
Section A – Introduction to International Trade

Learning Outcomes:

1. Define international trade.
2. Classify transactions into international trade and domestic trade.
3. Assess the benefits of international trade.

International Trade refers to all transactions that take place between countries that will lead to outflows/inflows of funds. So international trade is not just about selling/buying goods and services from abroad (i____________ and e____________), but also includes investing activities and borrowing.



Why trade with other countries?

Determine whether each transaction is an example of international trade or domestic trade

Transaction Description	**International Trade**	**Domestic Trade**
Sale of goods to a company in a different country.		
Purchase of raw materials from a local supplier.		
Export of software services to overseas clients.		
Buying products online from a retailer within the same country.		
Import of electronics from a foreign manufacturer.		
Selling agricultural produce to a local market.		

Section B – Factors Influencing International Trade and Competitiveness

Learning Outcomes:

1. State the factors that determine international competitiveness.
2. Elaborate on the factors that determine international competitiveness.
3. Assess the benefits of improving international competitiveness.

Specialisation is when one individual, region, or country concentrates in making one good.

Which product is each country well known for?

Country	Product
France	
Saudi Arabia	
Argentina	
Iceland	
Japan	
Switzerland	

When a country has a competitive advantage over another country, it is internationally more competitive. International competitiveness refers to the fact lower opportunity cost gives the country a competitive edge. Factors that influence international competitiveness:

- Productivity - ____

  ____
- Inflation - ____

  ____
- Exchange rates - ____

  ____
- Tax rates - ____

  ____
- Infrastructure - ____

  ____
- Cost of doing business - ____

  ____

When we talk about improving international competitiveness, we're referring to how well our country can compete in the global market. This is crucial because it impacts our economy, job market, and overall standard of living.

Benefits of improving international competitiveness:

1. **Economic Growth** – As our country becomes more competitive, we can export more goods and services. This increases our gross domestic product (GDP), leading to a healthier economy.
2. **Job Creation** – With economic growth comes job creation. As businesses expand to meet the demands of international trade, they need more workers. This can lead to more job opportunities in various sectors, reducing unemployment rates.

3. **Higher Standards of Living**: As our economy grows and jobs are created, the standard of living in our country generally improves. This means better income, improved healthcare, education, and overall better quality of life for the citizens.
4. **Enhanced Innovation and Technology**: To stay competitive, countries often invest in research and development. This leads to technological advancements and innovation, which can improve efficiency and productivity in various sectors.

Section C – Balance of Payments

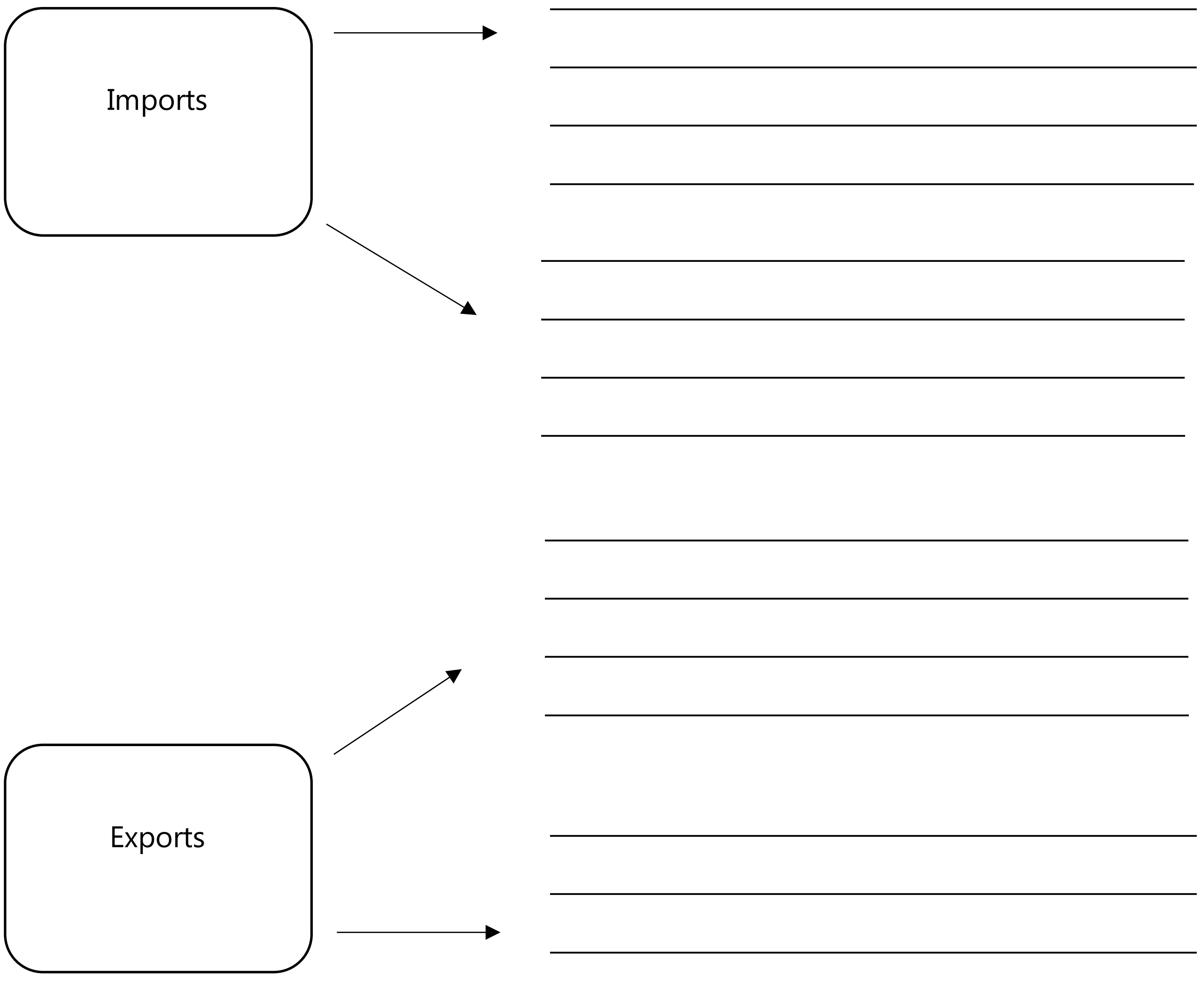
Learning Outcomes:

1. Explain exports, imports and/or Balance of Payments in terms of international currency flows.
2. Show how to calculate the balance of trade, and/or the current account balance and recognise whether such balances are in equilibrium, in surplus or in deficit.
3. Give reasons for a deficit or a surplus on the balance of trade and/or on the current account of the Balance of Payments.

Exports – The selling of goods and services to abroad, resulting in an ____________ of funds.

Imports – The buying of goods and services from abroad, resulting in an _____________ of funds.

Both imports and exports can be classified into two categories: visible and invisible.



The Balance of Payments is a statement/account in which a country records all of its transactions with the rest of the world. It records all inflows and outflows of funds of a country.

Components of the Balance of Payments

- Current Account
- Capital Account
- Financial Account
- Balancing Item

The Current Account

The Current Account measures how well the country is doing in all of its trade in goods and services, together with transfers of money and returns on investments. So, the current account involves four main components:

1. Visible Trade Balance - ____
   ____
   ____
2. Invisible Trade Balance - ____
   ____
   ____
3. Net interests, profits, and dividends - ______________________________
   ____
4. Transfers and Grants - ____
   ____

Exercise 1 – Calculate the Balance on the Current Account

Visible Exports	Visible Imports	Invisible Exports	Invisible Imports	Income	Transfers
Current Prices (Millions of €)					
784.2	1230.4	286.4	219.9	+21 -65.1	+48.6 -27.4

Balance of Payments - Malta		
	Outflow of Funds	**Inflow of Funds**

Exercise 2 – Calculate the Balance on the Current Account

Visible Exports	Visible Imports	Invisible Exports	Invisible Imports	Income	Transfers
Current Prices (Millions of €)					
800	500	600	400	+99 -72	+86 -97

Balance of Payments - Malta		
	Outflow of Funds	**Inflow of Funds**

The Capital Account

The Capital Account will include all transactions that will bring about a change in a country's assets and liabilities. This includes:

- Investment in other countries
- Granting of loans
- Borrowing from abroad.

The Financial Account

The financial account will also include:

- Government drawings on reserves of foreign currency to finance deficits; or
- Additions to reserves of foreign currencies resulting from surpluses.

Balancing Item

Due to the vast amount of transactions between one country and the rest of the world, there is bound to be errors and omissions. So, a balancing item is included in the Balance of Payments which represents these errors and omissions.

The Actual Picture

Table 4.1
BALANCE OF PAYMENTS
EUR millions

	2015	2016	2017	2017 Q1-Q3	2018 Q1-Q3
Current account	**226.6**	**356.7**	**1,173.9**	**1,001.0**	**1,100.7**
Goods	-1,969.5	-1,959.6	-1,478.1	-1,119.3	-1,152.1
Services	2,835.4	3,321.1	3,841.8	2,993.4	3,100.6
Primary income	-547.9	-893.8	-1,061.8	-778.6	-751.8
Secondary income	-91.3	-111.0	-128.0	-94.5	-96.0
Capital account	**268.8**	**32.3**	**60.2**	**28.8**	**29.9**
Financial account (1)	**263.1**	**835.1**	**1,288.8**	**1,141.1**	**827.6**
Errors and omissions	-232.3	446.1	54.8	111.3	-303.0

Source: NSO.
(1) Net lending (+) / net borrowing (-).

Explain the effect on the Balance of Payments for each of the following transactions

a. Some Maltese people went to Mexico on holiday and spend €2,000 on hotel accommodation and €600 on Air Malta tickets.
b. A Maltese firm sold €4,000 worth of lead glass to German tourists.
c. A British student reading for a degree at the University of Malta has received a €3,000 grant from the British High Commission.
d. A local firm bought €1,800 worth of clothes from Italy.
e. A Maltese firm bought shares €10,000 in a German PLC.

Classify the following transactions under the appropriate section of the Balance of Payments (mention the main section of the Balance of Payments and the sub-section where applicable):

a) Dividends and Interests earned in Malta and sent abroad total to 1,000.
b) Dividends and interests received from abroad 2,000.
c) Grants received by foreign students studying in Malta from their Governments amount to 3,000.
d) Exports of Goods amounts to 12,000.
e) Imports of Goods amounts to 22,000.
f) Exports of Services amounts to 35,000.
g) Imports of Services amounts to 7,000.
h) A Greek company invests 10,000 in a local entity.
i) Maltese entrepreneurs invest 1,800 in a New York business.
j) Malta lends the UK government 10,000 loan.

Surplusses or Deficits on the Balance of Payments

In order to maintain stability, the Balance of Payments should always balance. However, this may not always be the case as there may be a situation of a surplus or a deficit on one of the accounts.

Surplus – Inflows of foreign currency greater than outflows of foreign currency.

Deficit – Inflows of foreign currency less than outflows of foreign currency.

In the case of a **surplus**, the balance can be used to:

- Make investments overseas
- To increase a country's foreign reserves
- To repay any past borrowing
- To provide loans to other countries.

In the case of a **deficit**, the balance will have to be financed by:

- Attract investment
- Running down reserves
- Selling overseas
- Selling domestic assets
- Obtaining loans from the IMF or other institutions.

Is a deficit always bad? ____

____

____

Is a persistent current account deficit sustainable?

____

____

____

Correction of a Current Account Deficit

- Increase exports.
- Decrease imports.
- Protectionism.
- Influencing the rate of interest – through monetary policy.
- Deflationary fiscal policy.
- Devaluation of currency – effects of such measure are short-lived.

Section D – Economic Integration and Objectives in the European Union

Learning Outcomes:

1. State the main economic objectives of the European Union (EU). free trade area, customs union, common market, economic union, monetary union
2. Describe Free Trade Area, Customs Union, Common Market, Economic Union and/or Monetary Union.
3. Compare and contrast Free Trade Area, Customs Union, Common Market, including their impact on international trade.

The European Union (EU) is a unique political and economic partnership involving 27 European countries. It was created after World War II to foster economic cooperation, with the idea that countries that trade together are less likely to go to war with each other. Over time, the EU has grown and evolved to become a single market allowing for the free movement of goods, services, people, and capital.

The main objectives of the European Union:

- **Free Trade Area** – The EU aims to remove trade barriers and restrictions among member states to facilitate the free movement of goods and services. This objective promotes competition, improves efficiency, and enhances consumer choice within the union.

- **Customs Union** – The EU has established a common external tariff, meaning member states apply the same tariff rates to imports from non-member countries. This simplifies trade between countries.
- **Common Market –** Beyond free trade, the EU seeks to allow the free movement of capital, labour, goods and services. ____

  ____
- **Economic Union** – The EU strives for coordinated economic policies among member states. This includes common policies on agriculture, fisheries, regional development, and competition. The aim is to promote economic stability and growth across the union.
- **Monetary Union**: The EU's economic objectives include the adoption of a single currency, the euro, by many member states. This facilitates easier trade and investment, reduces exchange rate risk, and promotes price transparency and stability.

Exercise Set A

Exercise 1 – Multiple-Choice Questions

1. Which of the following best defines international trade?
   a) The exchange of goods and services within a single country.
   b) All transactions that involve outflows and inflows of funds between countries.
   c) Investment activities within a country.
   d) Borrowing from local financial institutions.

2. Which transaction is an example of domestic trade?
   a) Export of software services to overseas clients.
   b) Import of electronics from a foreign manufacturer.
   c) Sale of goods to a company in a different country.
   d) Purchase of raw materials from a local supplier.

3. Which of the following is NOT considered a part of international trade?
   a) Exporting goods to another country.
   b) Importing services from abroad.
   c) Investing in a foreign company's stocks.
   d) Selling goods to a local market.

4. Which of the following factors is likely to decrease a country's international competitiveness?
   a) High productivity.
   b) Low inflation.
   c) A strong currency.
   d) Low tax rates.

5. The Balance of Payments is primarily concerned with:
    a) The domestic distribution of wealth.
    b) The inflows and outflows of funds between a country and the rest of the world.
    c) The taxation policies of a country.
    d) The balance between government spending and revenue

6. Which of the following transactions would be recorded in the financial account of the Balance of Payments?
    a) Exports of goods to a foreign country.
    b) A foreign company investing in a local business.
    c) Imports of services from abroad.
    d) A government receiving grants from an international organisation.

<u>Exercise 2 – Multiple-Choice Questions</u>

Determine whether each of the following transactions is an example of international trade or domestic trade by ticking the appropriate column

	International Trade	Domestic Trade
Sale of goods to a company in a different country		
Purchase of raw materials from a local supplier		
Export of software services to overseas clients		
Buying products online from a retailer within the same country		

Exercise 3 – Short-answer questions

a. List the factors that determine international competitiveness.
b. Explain how productivity influences a country's international competitiveness.
c. Explain the difference between visible and invisible trade. Provide examples of each.
d. How does international trade lead to the inflow and outflow of funds in a country?
e. Describe the main differences between a Free Trade Area and a Common Market within the European Union.
f. Distinguish between the current account and the capital account in the Balance of Payments.
g. Why might a country experience a surplus on its current account? What could this indicate about the country's economy?
h. Explain how a persistent current account deficit might be corrected.
i. Using the data provided, calculate the balance on the current account:
    - Visible Exports: €800 million
    - Visible Imports: €500 million
    - Invisible Exports: €600 million
    - Invisible Imports: €400 million
    - Income: +€99 million
    - Transfers: -€72 million

Section D – Exchange Rates

Learning Outcomes:

1. Define exchange rates.
2. Calculate the impact of exchange rate changes on domestic prices.
3. Assess the importance of exchange rates in international trade.
4. List reasons affecting the appreciation and depreciation of a currency.
5. State that the demand for a currency depends on the country's exports.
6. State that the supply of a currency depends on the country's imports.
7. Illustrate linear Demand and Supply curves (sketch, plot) to show situations of equilibrium, excess demand (appreciation) and/or excess supply (depreciation) in foreign exchange (forex) markets with appropriate labelling of the axis and the curves.
8. Assess the effect on the equilibrium exchange rate of a shift of either the demand or supply curve or both as a result of an increase and/or decrease in a country's exports and imports.
9. Relate the effect of changes in the exchange rate to the relative price of goods and services traded by countries.
10. Evaluate possible advantages and disadvantages of a single currency

If you travel overseas you will need to have some notes/coins of the national currency of each country you visit in order to be able to buy things. In order for you to obtain such a currency, you need to ***swap/exchange*** your home currency (Euro) for the national currency of the country visited.

The amount you get in return for your own currency is called the exchange rate. So, payments for imports, exports and to make other payments overseas requires the exchange of different national currencies – this takes place in **global foreign exchange market**.

Like any other markets, the rate of exchange is determined by demand and supply in the foreign exchange market (Forex).

- The purpose of the foreign exchange market is to assist international trade and investment.
- In a typical foreign exchange transaction, a party purchases a quantity of one currency by paying a quantity of another currency.
- The foreign exchange market allows businesses to convert one currency to another. For example: it permits a U.S business to import European goods and pay *Euros*, even though the business's income is *U.S Dollars*.

A company in Canada imports machinery from Germany. Initially, the exchange rate is 1 CAD = 0.70 EUR, and the price of the machinery in Germany is 14,000 EUR. Calculate the price of the machinery in Canadian Dollars (CAD) before the exchange rate changes.

____

____

Suppose the exchange rate changes to 1 CAD = 0.65 EUR. Calculate the new price of the machinery in CAD.

____

____

Demand and Supply in the Foreign Exchange Market

The Demand for Euro in the foreign exchange markets

Euros will be demanded by households and firms in other countries outside the Eurozone when: ____

____

The Supply of Euro in the foreign exchange markets

Euros will be supplied by residents of the Eurozone when: _______________________

____

____

The Exchange rate is the price of a currency in terms of another currency

Depreciation – When the value of a currency falls.

Appreciation – When the value of a currency increases.

Online Purchasing and Exchange Rates

Step 1 – Foreign goods market – first you order the goods online

Step 2 – You pay and authorise withdrawal of Euros from your bank account

Step 3 – PayPal uses your euros to buy dollars

Step 4 – Goods are bought abroad using dollars

Currency Changes

€0.73 : $1	€1 : $1.37
€0.77 : $1	€1 : $1.30

The exchange rate of each currency in terms of another will be determined by the market demand and supply conditions for each of those currencies.

- Demand for a currency will contract as the price/exchange rate of that currency rises.
- Supply of a currency will tend to expand as its exchange rate rises.

How the Value of the Euro might Rise or Fall

How might the value of the Euro fall

Eurozone residents demand for US goods and services increases.

Eurozone residents offer more euro in exchange for US dollars.

In the foreign exchange market, the supply of euro increases – the demand for US dollars increases.

The value of the Euro in terms of the dollar falls.

The Euro buys fewer dollars, and dollars buys more euro

Example:

Exchange rate moves

€1 : $1.4

€1 : $ 1.2

How might the value of the Euro rise

US residents demand more Eurozone goods and services

US residents offer more US dollars in exchange for Euro

In the Foreign Exchange Market, the demand for Euro increases – the supply of the dollar increases.

The value of the Euro in terms of the dollar rises.

The Euro buys more dollars, and dollars buy fewer Euros.

Example:

Exchange rate moves

€1 : $1.4

€1 : $ 1.6

<u>Reasons for fluctuations in the value of currency</u>

a. Changes in the balance of trade in goods and services

  - When a country (ex UK) imports a greater value of goods and services than it exports, then it would have a current account deficit.
  - More currency being supplied to pay for imports and less demanded by overseas residents.
  - Price of currency depreciates

b. Inflation

  - If the Eurozone inflation rate is higher than that of other countries the price of Eurozone-produced goods would be rising faster than foreign prices.
  - As a result, Eurozone goods would become uncompetitive
    - Demand for Eurozone exports, and therefore for euro, would fall.
    - Demand for foreign imports, and therefore supply of Euro, would rise
    - As a result, the price of currency depreciates.

c. Changes in interest rates

  - When a country's interest rates are high, overseas residents may be keen to save or invest their money.
  - Demand for the currency rises, and it appreciates – foreigners more willing to invest in Malta.
  - If foreign interest rates increase, the local currency would depreciate.

d. Speculation

- A foreign currency speculator tries to make money by trading currencies.
- They would observe the market and sell/buy currency when they deem most profitable.
- Leads to shift in supply and demand of currencies leading to an appreciation/depreciation of currency.

<u>Effects of an Appreciation/Depreciation of Currency</u>

<u>1 – Balance of Payments</u>

Appreciation of currency occurs when for example €1 buys more $.

€1 = $1.8

€1 = $2

If the EU exports €1,000 worth of goods to the US,

Before – US paid __________ After – US paid ___________

So, Exports have become more expensive due to appreciation of the Euro.

If the EU imports $1,800 of goods from the US

Before EU paid __________ and after it pays _________________.

So, Imports have become cheaper due to appreciation of the Euro.

Depreciation of currency occurs when for example €1 buys less $

€1 = $1.8

€1 = $1.6

If the EU exports €1,000 worth of goods to the US

Before the US paid $1,800 and now the US pays $1,600

Therefore, exports have become cheaper due to depreciation of the Euro

If the EU imports $1,800 worth of goods from the US

Before the EU paid €1,000 and now the EU pays €1,125

Therefore, imports have become more expensive due to depreciation of the Euro.

As Currency Appreciates	As Currency Depreciates
Imports – Cheaper Exports – More Expensive	Imports – More Expensive Exports – Cheaper
Less goods exported More goods imported	More goods exported Less goods imported
Balance of Trade Deficit increases	Balance of Trade becomes a surplus

2 – Employment

As Currency Appreciates	As Currency Depreciates
Imports – Cheaper Exports – More Expensive	Imports – More Expensive Exports – Cheaper
Less goods exported More goods imported	More goods exported Less goods imported
Local Production decreases – employment decreases	Local production increases – employment increases

3 – Inflation

As currency appreciates – Inflation can be cured.

Imported cost of production decreases	For foreigners our products are more costly
Cost of production decreases	Demand for local products decreases
Cost push inflation being cured	Ad shifts in – demand pull inflation being cured.

<u>Single-Currency – Arguments for and against</u>

Advantages of a Single Currency

1. Stable Exchange Rates - Countries using the Euro don't face exchange rate fluctuations within the Eurozone, making trade and investment easier and more predictable.
2. Price Comparisons – A single currency allows consumers and businesses to easily compare prices across different countries, promoting competition and potentially lowering prices.
3. Closer Economic Ties – Sharing the Euro helps strengthen economic integration, fostering stability and growth across the Eurozone.
4. Global Influence - The Euro gives the Eurozone greater influence in global markets and international economic discussions.
5. Lower Costs – With no need for currency exchange within the Eurozone, businesses and travellers save on transaction costs.

Disadvantages of a Single Currency

1. Loss of Control – Countries cannot set their own interest rates or monetary policies, as these are controlled by the European Central Bank (ECB), which may not suit their individual economic needs.
2. Economic Inequality – A single policy may not work well for all countries, especially if some face economic difficulties that others do not.
3. Strict Fiscal Rules – Countries must follow strict budget rules to maintain the Euro's stability, which can limit their ability to respond to economic crises.
4. Tensions and Discontent - The lack of flexibility to address national economic problems can cause political and social tensions within member countries.